BUSINESS LAW SECTION

THE STATE BAR OF CALIFORNIA

Thursday, December 12, 2002

Kathy Womack
Office of Law and Legislation
California Department of Corporations
1515 “K” Street, Suite 200
Sacramento, CA 95814-4052

Re: Proposed Change in Department of Corporations’ Policy re Filings under California Franchise Investment Law

Dear Ms. Womack:

As you know, the Franchise Law Committee, a standing committee of the State Bar’s Business Law Section, consists of California attorneys who practice extensively in the franchise law area and includes among its members attorneys who represent Franchisees, Franchisors or both. A representative of your office has attended our meetings and has been in regular contact with us on matters of mutual interest.

From time-to-time the Franchise Law Committee considers items of concern to practitioners in the franchising field and, on occasion, may make proposals for legislative or regulatory change. Over the past few years, such proposals have resulted in additions or changes to the California Franchise Investment Law.

During the last year, the Franchise Law Committee has discussed the need for possible change in the Department’s processing of applications for registration, amendments and renewals as filed by Franchisors. After extensive study and discussion, and a unanimous Franchise Law Committee vote (with one abstention), we would like to suggest certain changes in the Department’s processing of such filings. Our research indicates that these changes could be made without the necessity of revising any existing portions of the California Franchise Investment Law or accompanying regulations.

SUMMARY:

California is currently one of a limited number of states requiring pre-sale filing of franchise Offering Circulars (UFOCs), along with review and comment on such filings.[1] The vast majority of states do not require pre-sale filing of franchise Offering Circulars and a number of states that continue to require pre-sale filing have recently adopted practices substantially similar to those suggested in this proposal.

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[1] For purposes of this proposal, initial filings, amendments (whether pre- or post-effective) and renewals are treated as essentially similar.

Our suggestions seek to change the Department's current office policy from a full pre-offer and sale review and comment on UFOCs to a limited review with respect to (a) assurance of adequate financial arrangements and (b) inclusion of certain mandatory language as required by California in the past, only.

This change would allow the Department to significantly concentrate its resources into a more effective and efficient system focused on enforcement against non-compliant Franchisors, rather than the current system, which requires the Department to review and analyze UFOCs from essentially the entire population of Franchisors seeking to do business in California. This change would also bring California in line with other registration states that have, over recent years, formally or by office policy, modified or eliminated their UFOC review procedures in this manner, namely, Hawaii, Indiana, Michigan, South Dakota and Wisconsin.

PURPOSE:

It appears from initial research that there is no empirical evidence to show that the costly and cumbersome pre-sale UFOC review system in California provides any incremental benefit or protection to California consumers. Further, given a recent Federal Trade Commission report that looked at recent FTC enforcement actions, 75% of the actions related to "business opportunities", with only 6% relating to traditional franchisors. (Testimony of J. Howard Beales, III, Director of the FTC's Bureau of Consumer Protection, before the House Subcommittee on Commerce, Trade and Consumer Protection of the Committee on Energy and Commerce, June 25, 2002.) Mr. Beales went on to state that "based upon the Commission's two decades of experience in enforcing the Franchise Rule, it is clear to us that deceptive business opportunity sales, <u>rather than business-format franchise sales</u>, remains a persistent cause of significant injury to American consumers." (Emphasis added).

As described in more detail below, several registration states have recently transitioned from pre-sale review to a notice filing regimen, either by statutory/regulatory revision or by a change in administrative policy. Based on detailed interviews with these state personnel, <u>none</u> of these states report an increase in office actions or complaints as a result of the change, while consumers are still afforded the same remedies as before for violations by transgressing franchisors. Below we have set out a brief background on the current status of UFOC review in the U.S. and a summary of the informal research we conducted in the states and other jurisdictions that have recently switched from pre-sale review to notice filing.

Of the fifteen franchise states that have enacted franchise "registration" laws, nine[2] states, including California, currently generally require pre-sale registration of disclosure documents (UFOCs) whereby the state must review and comments on the UFOC before the franchisor may offer franchises in the state.

Three other states (Michigan, Indiana and Wisconsin) have amended their franchise laws and now require the franchisor to only file a "notice" and "information" copy of the UFOC with the state, pre-sale review and comment having been dispensed with.

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[2] California, Illinois, Maryland, Minnesota, New York, North Dakota, Rhode Island, Virginia, Washington.

Two other registration states, Hawaii and South Dakota, realizing that an amendment to existing law was unnecessary, amended their office policy along the lines of the other three notice states. Given our review of the California Investment Law (CFIL), a similar office policy change in California could easily transition California to a procedure dispensing with line-by-line review of, and comment on, UFOCs, freeing up significant resources, while not adversely affecting (and likely increasing) the protection of California consumers. Our review indicates that no action by the legislature would be necessary to amend the CFIL to accomplish this result, nor would changes need to be made in existing regulations.

The rest of the states in the country (approximately 35 “non-registration states”) do not require pre-sale registration or review of UFOCs nor the filing of a notice. This is an important point to understand: The vast majority of states (including major commercial centers such as Ohio, Pennsylvania, Massachusetts, Texas, etc.) do not require pre-offer/sale review of UFOCs and there is no empirical evidence that any greater number of instances of fraud or other harm to Franchisees exists in those states. This dearth of evidence, combined with the federal requirement discussed below for pre-sale disclosure and a perceived need for reallocation of state resources, has resulted in a substantial trend in recent years away from requiring pre-offer/sale review of UFOCs.

The Federal Trade Commission Franchising Rule (expected to be updated within the next year) currently requires pre-sale disclosure in all jurisdictions throughout the U.S., using essentially the same basic form of UFOC as in California. Subject to very limited exemptions, the FTC Rule requires pre-sale delivery of a UFOC to all prospective Franchisees at least 10 business days prior to the prospective franchisee signing any binding documents or paying any monies to the franchisor. This FTC requirement results in prospective franchisees receiving full pre-sale disclosure in **all** states, including the 30+ "non-registration" states, as well as all registration states.

RESEARCH:

To best determine whether this proposal (and our initial anecdotal assumptions) was appropriate, we set out to research those registration states that had recently moved to a notice filing regimen, asking various questions regarding consumer complaints, office actions, etc. both before and after the transition.

Regulators in the states of Hawaii, Michigan, South Dakota, Indiana and Wisconsin were contacted. (Other states were contacted but did not respond in time for this report.) Below is a summary of the findings from this research:

- All states reported that the number of stop orders issued by the states has not increased and that the transition process has basically been a "non-event,” other than the reduced paperwork associated with the old pre-review. [Note that under this proposal, California would retain its ability to issue stop orders, under exactly the same conditions as it can now.]

- In the states where the change was most recent (Indiana and South Dakota), they acknowledged that not a great deal of time as passed since the change, but that they had not noticed any significant increase in franchise enforcement actions. In South Dakota specifically, the regulator reported no change in complaints, which was "zero" prior, and after, to the change in office policy.

- Three of the state regulators also commented that because the state had not changed the available causes of actions afforded to the franchisees under the new law (deceptive practices, etc.), as would remain the case in California under this proposal, they felt "comfortable" with the new notice filing. One regulator also noted that did not perceive much of a change, as they still had the same remedies available to them (stop orders, impoundments, etc).

- In South Dakota, the regulator noted that due to the new review policy, they were forced to focus on the larger material items in the UFOC, such as the financial statements and general content of the UFOC (that each Item is present and addressed). All in all, she reported that they were very happy about the change in office policy in that it has made their jobs "a lot easier and more efficient." This appears to be consistent with our experience in California, where a disproportionate number of comments focus on minor items such as formatting, grammar, etc.

- The Wisconsin regulator commented that the notice filing process is now a "smooth process" and that for the majority of the time the UFOCs are only missing "minor" items that do not warrant a stop order.

HISTORY:

We are not aware of any similar proposals currently under consideration.

PENDING LITIGATION:

We are not aware of any litigation currently pending, which would be impacted by this regulation, if adopted.

LIKELY SUPPORT AND OPPOSITION:

This proposal should have the support of both prospective franchise investors and franchisors, as well as the professionals that represent these parties. We also believe that support would be likely from the International Franchise Association.

These parties recognize that franchising today is not how franchising was done thirty years ago. Franchisors and franchisees alike are more sophisticated and experienced and understand that the days of "churn and burn" franchising are over. As indicated by the FTC research above, as well as the experience of the other recently converted notice filing states, California is expending precious resources on a compliance program based on the perils of the past. Under a notice filing regimen, saved resources could be targeted at fortifying enforcement, focusing the Department's efforts on punishing actual violators instead of policing the overwhelming majority of modern franchisors that are complying with the CFIL and FTC Rule.

The Department would continue to protect California consumers by requiring that:

(a) <u>pre-sale disclosure to prospective franchisees will remain mandated</u>,

(b) <u>copies of UFOCs and appropriate notices will continue to be filed with the Department, along with filing fees</u>,

(c) California-specific language will continue to be required in UFOCs,

(d) the Commissioner will retain the authority to issue stop orders and require escrows, impoundments, guarantees, etc. as appropriate based on a franchisor not having adequate financial resources, and

(e) franchisees will retain all rights to sue for violations of the CFIL.

Potential opponents may feel that without review by state administrators, some inexperienced franchisors may prepare UFOCs without input from experienced franchise counsel and omit or misstate information, which otherwise may be caught by the current administrative review. Of course, this problem exists in all but 9 states currently (the growing majority that, along with the FTC, do not require pre-sale review and comment). As referenced above, we have found no evidence that instances of fraud or otherwise are more prevalent in non-registration states or in notice states such as Indiana or Michigan.

Again, the concern noted above does not mean that all such information that may be caught by such administrative pre-review would be material enough to substantively misrepresent the franchise to the prospective franchisee. Of course, where a UFOC filing is made by a new Franchisor unrepresented by counsel, the Department would retain the ability to engage in more detailed review, if appropriate.

Lastly, as the Department and the CFIL itself indicates, pre-review of the UFOC by the Department is not an endorsement of the franchise or a representation by the Department that the franchise offering is without misrepresentations by the Franchisor. Accordingly, even *after* pre-review, the prospective franchisee is left with the same remedies for violations as he or she would be left with under a notice filing regimen.

[Note that revenue to the State would not decline, as filing requirements and related fees would remain in place.]

Some observers may feel that many undercapitalized franchisors will not be detected until too late in the process. Again, there is no evidence in the other non-registration or notice states that this has surfaced as a material issue. As is practiced in South Dakota and Hawaii under their revised office policies, they still are at liberty to issue a stop order if they feel the franchisor's audited financial statements do not provide sufficient confidence that the franchisor's obligations can be completed and we suggest that that ability be retained in California. If a franchisor does not have adequate financial resources, the Department retains its ability to require escrows, impoundments, guarantees, surety bonds, etc.

In addition, the Department would continue to review UFOCs for the limited purpose of assuring that mandated California-specific language continues to appear in the UFOC, as required by Reg. 310.114.1.

Lastly, some within the Department may feel that since California was the pioneer in franchising with the CFIL in 1971, that the state owes some kind of duty to the rest of the country to be the standard bearer for the most rigorous UFOC review. We would wholeheartedly support this intention if it could be shown that this was the most effective means to the ends of assuring that California consumers are protected when obtaining a franchise. However, the reality seems to be different: Those states that have moved to a "non-review" procedure have not reported any instances of increased problems and the current California policy drains resources from enforcement against the relatively few “bad apple” franchisors and focuses it instead on the vast majority of fully compliant Franchisors. The time seems to be appropriate to re-direct the State’s limited resources to where they can be of the greatest use and effectiveness – enforcement against actual violators rather than a line-by-line review of UFOCs.

FISCAL IMPACT:

This proposal would save significant monies spent on maintenance and administration of the current pre-sale disclosure requirements. While we understand that it is the state's province to determine appropriate allocation of resources, we strongly recommend that the resources that are saved by eliminating pre-sale review and comment be reallocated to enforcement, thereby concentrating limited resources not on the vast majority of legitimate franchisors but on the few who may violate the rules. We do not propose that the filing fees currently in place be reduced or eliminated in any way. Therefore, income to the state will remain at its current levels, with no increase in costs and possible savings.

We appreciate this opportunity to share our proposal with you. If you have any questions or need any further information, please feel free to contact David E. Holmes, Esq. at (888) 547-0697 who was primarily responsible for this proposal or any of the committee members listed below. We very much look forward to working with you and other members of the Department on this and other matters.

Sincerely yours,

Lori Lofstrom, Esq. .
Co-Chair Franchise Law Committee

cc: Terry Miller, State Bar Office of Governmental Affairs
Charles Rumbaugh, Esq. -Co-Chair
David E. Holmes, Esq. –Co-Vice Chair
Glenn Plattner, Esq. –Co-Vice Chair
Robin Day Glenn, Esq.-Executive Committee Liaison
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